

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 ROME 10168

C O R R E C T E D C O P Y (MRN 10168 VICE 0168)

LIMDIS

USEEC USOECD

E.O. 11652: GDS
TAGS: EFIN, IT
SUBJECT: AMBASSADOR'S MEETING WITH GOVERNOR OF BANK OF ITALY BAFFI

1. SUMMARY. THE AMBASSADOR, ACCOMPANIED BY TREAS ATT,
MET WITH GOVERNOR OF BANK OF ITALY BAFFI ON MORNING
OF JUNE 1, FOR A TOUR D'HORIZON OF THE ECONOMIC SITUATION.
AS USUAL, THE GOVERNOR WAS CANDID, CONCISE AND VERY
FORTHCOMING IN HIS ANALYSIS OF AND VIEWS ON THE ECONOMIC
PROBLEMS FACING ITALY. WHILE MOST OF WHAT HE HAD TO SAY
HE HAD SAID DURING HIS ANNUAL SPEECH BEFORE THE BANK'S
ASSEMBLY YESTERDAY (SEPTEL), HE DID SHARE WITH US A NUMBER OF
INTERESTING INSIGHTS WHICH WERE NOT INCLUDED THEREIN.
IN SUMMARY, THE THEME OF BAFFI'S REMARKS WAS THIS:
ITALY WILL GET THROUGH 1978 WITHOUT DIFFICULTY ON BOTH
THE INFLATION AND THE BALANCE OF PAYMENTS FRONTS:
HOWEVER, UNLESS SOMETHING IS DONE QUICKLY TO REDUCE THE
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SIZE OF THE PULBIC SECTOR DEFICIT AND TO MODERATE LABOR
COST INCREASES, ANOTHER ECONOMIC CRUNCH IS LIKELY TO
DEVELOP IN 1979. BAFFI BELIEVED THAT THE UPCOMING
DISCUSSIONS WITH IMF ON A NEW LETTER OF INTENT
WOULD HAVE AN IMPORTANT POSITIVE IMPACT IN GETTING THE
GOVERNMENT AND THE POLITICAL FORCES TO FOCUS ON THE
DIFFICULT PROBLEMS FACING THE ECONOMY. END SUMMARY.

2. INFLATION. BAFFI SAID THAT THE MAIN MESSAGE OF HIS SPEECH YESTERDAY WAS TO WARN HIS AUDIENCE OF THE CONTINUED DANGERS OF INFLATION. WHILE THE BANK OF ITALY LACKS THE MEANS TO REDUCE LABOR COSTS, IMPROVE PRODUCTIVITY, AND CUT THE PUBLIC SECTOR DEFICIT, IT CAN AND SHOULD POINT TO THE CONSEQUENCES OF FAILURE TO REVERSE PRESENT TRENDS IN THESE AREAS. BAFFI INDICATED THAT IN RECENT MONTHS INFLATION HAD STOPPED FALLING, STABILIZING AT THE UNACCEPTABLY HIGH LEVEL OF 13 PERCENT ANNUAL RATE. THE AMBASSADOR ASKED BAFFI WHETHER HE SHARED THE VIEW THAT THE SO-CALLED "MINI-BUDGET" APPROVED BY THE COUNCIL OF MINISTERS LAST FRIDAY (ROME 9971) WAS A DISAPPOINTMENT, SINCE IT FAILED TO ADDRESS THE DIFFICULT ISSUE OF REDUCING PUBLIC SECTOR EXPENDITURES. THE AMBASSADOR FURTHER WONDERED WHETHER THIS MADE BAFFI PESSIMISTIC ABOUT THE OUTLOOK FOR INFLATION. WHILE AGREEING WITH THE AMBASSADOR'S ASSESSMENT OF THE SO-CALLED "MINI-BUDGET", BAFFI STATED THAT ONE SHOULD NOT BE SO PESSIMISTIC.

3. CREDIT EXPANSION. HE BELIEVED THAT THE EXPECTED CREDIT EXPANSION FOR 1978 WAS ONE PARTICULAR REASON FOR CONCERN. ALTHOUGH THE ENLARGED PUBLIC SECTOR DEFICIT IS PRESENTLY ESTIMATED AT 35,000 BILLION LIRE, HE INDICATED THAT 5,000 BILLION LIRE REPRESENT REPAYMENT OF PREVIOUSLY-
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INCURRED PUBLIC SECTOR DEBTS. THUS, IN TERMS OF CREDIT ALLOCATION BETWEEN THE PRIVATE AND PUBLIC SECTORS, ONE SHOULD REALLY FOCUS ON A DEFICIT OF 30,00 BILLION LIRE, SINCE THE PRIVATE SECTOR WILL GET MOST OF THE 5,000 BILLION LIRE REPAYMENT. GIVEN THE EXPECTED TRENDS IN THE BALANCE OF PAYMENTS AND INDUSTRIAL PRODUCTION, THE BANK OF ITALY ESTIMATES THE ECONOMY CAN SUPPORT IN 1978 A TOTAL CREDIT EXPANSION OF 44,000 BILLION LIRE. ASSUMING NO REDUCTION IN THE UNDERLYING PUBLIC SECTOR DEFICIT--AN ASSUMPTION WHICH HE DOES NOT NECESSARILY AGREE WITH--THE PRIVATE SECTOR WOULD RECEIVE AT LEAST 14,000 BILLION LIRE IN NEW CREDIT, AN INCREASE EQUAL TO THAT OF 1977.

4. WAGES. BAFFI STRESSED THAT IT WAS URGENT TO CONTAIN EXCESSIVE CREDIT EXPANSION, SINCE ITALY'S SYSTEM OF WAGE INDEXATION PERMITS EXCESS DEMAND TO BE QUICKLY TRANSFERRED INTO PRICE INCREASES. HE SAID MONEY ILLUSION IS NOT OPERATIVE IN ITALY, SINCE WAGE EARNERS, PENSIONERS, AND TO LESSER EXTENT SAVERS, ARE ALL INDEXED TO INFLATION. THIS IS A FUNDAMENTAL WEAKNESS IN ITALY'S MONETARY MECHANISM.

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C O N F I D E N T I A L SECTION 2 OF 2 ROME 10168

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WITH RESPECT TO WAGE INDEXATION, BAFFI NOTED THAT THE LEADER OF THE COMMUNIST-AFFILIATED LABOR CONFEDERATION (CGIL) HAD IN PRIVATE CORRESPONDENCE WITH HIM CONCEDED THAT WAGE INDEXATION WAS INFLATIONARY. THE GOVERNOR THEN WENT ON TO READ PORTIONS OF A LETTER HE RECEIVED FROM LAMA IN 1976 IN WHICH THE LATTER MAINTAINED THAT FULL INDEXATION WAS ESSENTIAL FOR THOSE EARNING SUBSISTENCE-LEVEL WAGES, BUT THAT, FOR THOSE EARNING HIGHER SALARIES, PERHAPS THERE COULD BE ROOM FOR MODERATION. BAFFI REFERRED TO AN INTERVIEW GIVEN BY LAMA TO TURIN'S DAILY LA STAMPA LAST SATURDAY (SEPTEMBER) IN WHICH HE CONFIRMED THAT THE WAGE POLICIES OF THE LAST DECADE HAVE FAVORED THE EMPLOYED AGAINST THE UNEMPLOYED OR, TO USE LAMA'S TERM, "PITTED FATHER AGAINST SON". HE SAID UNFORTUNATELY OTHER LABOR LEADERS DO NOT NECESSARILY SHARE LAMA'S VIEWS, NOR IS THERE ANY ASSURANCE THAT LAMA COULD DELIVER THE UNIONS.

5. IMPACT OF RECENT ADMINISTRATIVE ELECTIONS. TURNING
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TO THE IMPACT OF RECENT ADMINISTRATIVE ELECTIONS IN

WHICH THE COMMUNIST PARTY (PCI) SUFFERED HEAVY LOSSES AT THE EXPENSE OF BOTH THE CHRISTIAN DEMOCRATS (DC) AND SOCIALISTS (PSI), BAFFI OPINED THAT THE OUTCOME WOULD LEAD THE PCI TO TAKE A MORE "DEMAGOIC" APPROACH TOWARD ECONOMIC PROBLEMS IN ORDER TO DEFEND ITSELF AGAINST ITS BASE. ON THE OTHER HAND, HE THOUGHT THE PSI WAS ACTING MORE RESPONSIBLY TOWARD ECONOMIC ISSUES, PERHAPS FEELING MORE CONFIDENT AFTER THE ELECTIONS. IN RESPONSE TO THE AMBASSADOR'S QUESTION AS TO WHY THE DC DID NOT TAKE A MORE RESPONSIBLE ATTITUDE SINCE IT, TOO, GAINED SIGNIFICANTLY AT THE POLLS, BAFFI REPLIED THAT THE PROBLEM WITH THE DC WAS REALLY ONE OF LACK OF LEADERSHIP. SAYING THAT THE DC STRUCTURE WAS LIKE A "TRUNCATED PYRAMID", HE BELIEVED THERE WAS NO ONE WITHIN THE DC WITH SUFFICIENT POWER TO COORDINATE ECONOMIC POLICIES. HE SAID MINISTERS WERE MORE CONCERNED ABOUT IMMEDIATE PROBLEMS, SUCH AS BAILING OUT FIRMS IN FINANCIAL DIFFICULTIES, RATHER THAN WITH LONGER-TERM POLICIES.

6. ROLE OF THE IMF. BAFFI FELT THAT THE UPCOMING NEGOTIATIONS WITH THE IMF ON A NEW LETTER OF INTENT WOULD BE A POSITIVE ELEMENT. HE THOUGHT THE FUND COULD PROVIDE A RATIONALE FOR THE GOVERNMENT TO TAKE SOME OF THE DIFFICULT DECISIONS THAT HAVE HERETOFORE BEEN POSTPONED. THE FUND WOULD ACT AS A BALANCE AGAINST THOSE FORCES WHICH FAVOR PROCRASTINATION. HE CONFIRMED THAT ITALY WOULD TRY TO NEGOTIATE A NEW LETTER OF INTENT FOR 1978 AND 1979 AND PERHAPS EVEN BEYOND.

7. OUTLOOK FOR THE ECONOMY AND THE LIRA. BAFFI PREDICTED THAT THE GROWTH RATE IN 1978 WOULD BE AROUND 2 1/2 PERCENT, A RATE WHICH MAY BE SURPASSED IF THE TREND IN CONFIDENTIAL

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INDUSTRIAL PRODUCTION FOR THE FIRST FOUR MONTHS CONTINUES FOR AWHILE. A GROWTH OF 2.5 PERCENT IMPLIES A GROWTH OF 4 1/2 PERCENT BY THE END OF THE YEAR (COMPARED TO THE LAST PART OF 77). THIS 4.5 PERCENT RATE MAY CONTINUE INTO 1979, IF INFLATION REMAINS UNDER CONTROL. AS FOR THE BALANCE OF PAYMENTS, ALTHOUGH HE PREDICTED A NEW CURRENT ACCOUNT SURPLUS OF \$2-2.5 BILLION IN HIS SPEECH YESTERDAY, HE TOLD US THAT IT COULD REACH CLOSE TO \$3 BILLION. HE CONCLUDED THAT ITALY THUS HAD SOME MARGIN LEFT, GIVING IT SUFFICIENT TIME TO MAKE AN ATTACK ON THE PROBLEMS OF LABOR COST AND PUBLIC SECTOR DEFICIT, IN ORDER TO AVOID ANOTHER CRISIS. WITH RESPECT TO THE LIRA, BAFFI SAID THAT AS LONG AS THE DOLLAR REMAINS WEAK, THE BANK WOULD PURSUE THE POLICY OF PEGGING THE LIRA TO THE DOLLAR SHOULD THE DOLLAR STRENGTHEN, HOWEVER, OR PER UNIT LABOR COSTS INCREASES NOT MODERATE, THE THE BANK

OF ITALY MAY HAVE TO LET THE LIRA DEPRECIATE AGAINST
THE DOLAR IN 1979.GARDNER

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